



State of Idaho

Internal Control Report

Independent Auditor's Report on Internal Control Over
Financial Reporting and on Compliance and Other Matters
Based on an Audit of Financial Statements
Performed in accordance with *Government Auditing Standards*

Fiscal Year 2013



Legislative Services Office Idaho State Legislature

Jeff Youtz
Director

Serving Idaho's Citizen Legislature

January 30, 2014

Honorable C.L. "Butch" Otter, Governor
Honorable Members of the Legislature
Honorable Brandon D. Woolf, State Controller

We are pleased to submit the State of Idaho *Internal Control Report* as it relates to our audit of the statewide *Comprehensive Annual Financial Report (CAFR)* covering the fiscal year ended June 30, 2013. This *Internal Control Report* is an integral part of the *CAFR* audit process and is required by *Government Auditing Standards* issued by the Comptroller General of the United States.

These standards require that we consider the internal control over financial reporting and disclose weaknesses that could have a material effect on the financial statements. We are also required to perform and disclose the results of tests of compliance with certain laws, regulations, and other requirements that could have a direct and material effect on the financial statement amounts.

The results of our audit identified four significant deficiencies in internal control, two material weaknesses in internal control, and one material noncompliance with laws, rules, and regulations. Although the risk of misstatement exists as a result of these issues, none of these weaknesses resulted in material misstatements that were not corrected as a result of the audit. As such, we were able to issue an unmodified opinion on the financial statements.

This report is available on our website at www.legislature.idaho.gov, and the *CAFR* can be obtained from the Idaho State Controller's Office on its website at www.sco.idaho.gov or by calling 208-334-3100.

Sincerely,

A handwritten signature in black ink that reads "April Renfro".

April Renfro, CPA, Manager
Legislative Audits Division

Mike Nugent, Manager
Research & Legislation

Cathy Holland-Smith, Manager
Budget & Policy Analysis

April Renfro, Manager
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Glenn Harris, Manager
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Legislative Services Office Idaho State Legislature

Jeff Youtz
Director

Serving Idaho's Citizen Legislature

December 23, 2013

Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Honorable C.L. "Butch" Otter, Governor
Honorable Members of the Legislature
Honorable Brandon D. Woolf, State Controller

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Idaho as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise the State of Idaho's basic financial statements, and have issued our report thereon dated December 23, 2013. Our report includes a reference to other auditors who audited the financial statements of Boise State University, Eastern Idaho Technical College, Idaho State University, Lewis-Clark State College, University of Idaho and their respective component units, Idaho Potato Commission, Idaho Dairy Products Commission, Idaho State Bar, Idaho Wheat Commission, Endowment Fund Investment Board, State Lottery Commission, Public Employee Retirement System of Idaho, Public Employees' Deferred Compensation Plan, Idaho Judges' Retirement Fund, IDEal Idaho College Savings Program, Idaho Individual Risk Reinsurance Pool, Idaho Small Employer Health Reinsurance Program, Idaho State Building Authority, Idaho Bond Bank Authority, and the Idaho Housing and Finance Association as described in our report on the State of Idaho's financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors. The financial statements of the Eastern Idaho Technical College Foundation, Lewis-Clark State College Foundation, Boise State University Foundation, Idaho State University Foundation, and the Public Employees' Deferred Compensation Plan were not audited in accordance with *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the State of Idaho's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State of Idaho's internal control. Accordingly, we do not express an opinion on the effectiveness of the State of Idaho's internal control.

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Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying Schedule of Findings and Responses, we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying Schedule of Findings and Responses to be material weaknesses: 2013-106 and 2013-107.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the accompanying Schedule of Findings and Responses to be significant deficiencies: 2013-101, 2013-102, 2013-104, and 2013-105.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of Idaho's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying Schedule of Findings and Responses as items: 2013-103.

State of Idaho's Responses to Findings

The State of Idaho's responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Responses. The State of Idaho's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Sincerely,

A handwritten signature in black ink that reads "April Renfro". The signature is written in a cursive, flowing style.

April Renfro, CPA, Manager
Legislative Audits Division

**STATE OF IDAHO
INTERNAL CONTROL REPORT
SCHEDULE OF FINDINGS AND RESPONSES
FOR THE YEAR ENDED JUNE 30, 2013**

CONTROLLER, OFFICE OF THE STATE

- 2013-101 Internal control weaknesses allowed misstatements in the statewide financial statements to go undetected.
- 2013-102 Reporting for the Idle Pool in the statewide financial statements contains a \$27.2 million understatement and a \$20.8 million overstatement for a net understatement of \$6.4 million.

HEALTH AND WELFARE, DEPARTMENT OF

- 2013-103 Hospital assessments of \$14.7 million were levied and collected without statutory authority.
- 2013-104 Financial reporting processes contain significant deficiencies in internal control allowing several errors in various closing packages to go undetected.

TAX COMMISSION, IDAHO STATE

- 2013-105 Estimates used to determine the amount of taxes receivable accrued at year-end are not properly evaluated for reliability, resulting in misstatements.

TREASURER, OFFICE OF THE STATE

- 2013-106 The Office of the State Treasurer inappropriately transferred investments from the Local Government Investment Pool to the Idle Pool resulting in a disproportionate share of investment losses incurred by the State.
- 2013-107 The Office of the State Treasurer misclassified one security in the Idle Pool investment closing package.

**STATE OF IDAHO
INTERNAL CONTROL REPORT
FINDINGS AND RESPONSES
FOR THE YEAR ENDED JUNE 30, 2013**

CONTROLLER, OFFICE OF THE STATE

FINDING 2013-101

Internal control weaknesses allowed misstatements in the statewide financial statements to go undetected.

Type of Finding: Significant Deficiency

Criteria: The internal control integrated framework published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) identifies control activities that help ensure management directives are carried out throughout the operation. Approvals, authorizations, verifications, reconciliations, and supervisory controls and reviews are all control activities that support this objective.

Condition: Several misstatements were identified that exceeded our trivial materiality threshold, but did not exceed materiality. They were all communicated during the audit process. The most significant errors include:

- Testing of the Proprietary Funds Statement of Revenues, Expenses, and Changes in Fund Net Position determined that \$46.9 million in scholarship allowances for the University of Idaho, Idaho State University, and Eastern Idaho Technical College were inappropriately netted against student tuition and fees, rather than being reported on the designated financial statement line of Scholarship Allowances.
- Testing of the Proprietary Fund Statement of Cash Flows determined that:
 - \$6.4 million reported as Purchase of Investments in the Unemployment Compensation column was misclassified and should have been reported as Redemption of Investments. This correction was made on the final draft of the financial statements. However, a previous adjustment of \$3.4 million to reclassify the change in the fair market value of investments was also removed, thereby understating Receipt of Interest and Dividends and overstating Purchase of Investments by this amount.
 - \$6.7 million in loan write-offs in the Loan column was not disclosed as a noncash transaction. In addition, the amount was not properly removed from the cash flow statement, thereby overstating Redemption of Investments and Purchase of Investments.
 - \$4.6 million for the Redemption of Investments for the Internal Service Funds column was misclassified as Purchases of Investments.
- Investments of \$213.9 million were not properly classified as restricted for the University of Idaho Foundation on the Component Units Statement of Net Position. In addition, \$5.9 million was not properly restricted for the Lewis Clark State College Foundation.

- Note 2: Deposits, Investments, Derivative Instruments, and Restricted Assets contained several errors within the note disclosure and supporting schedules. These included:
 - Cash sureties in the amount of \$3.8 million for the Industrial Commission were not included in supporting schedules.
 - \$6.9 million in U.S. Government agency obligations for Petroleum Clean Water Trust Fund were incorrectly included as corporate obligations. In addition, this amount was excluded from the concentration of credit risk disclosure.
 - Restricted assets in the amount of \$221.7 million for the University of Idaho Foundation were not included in the Restricted Assets schedule. This correction was made on the final draft of the financial statements.
 - Information included in the disclosure for Idaho Housing and Finance Association's (IHFA) derivatives did not agree with IHFA's audit report or to the Component Unit financial statements. The deferred inflows and deferred outflows were both disclosed as \$84.0 million in the note. However, the Statement of Net Position correctly reported deferred inflows of \$5.0 million and deferred outflows of \$87.7 million. In addition, the non-effective interest rate swaps were reported in the note as a positive \$3.8 million; however, the IHFA's audit report reported a negative \$3.8 million.
- Note 5: Noncurrent Receivables did not include a reduction of \$9.8 million related to a provision for loan losses as reported by IHFA.
- Note 10: Leases was understated by \$5.2 million in operating leases as several entities that receive outside audit reports were excluded.
- Note 12: Bonds, Notes, and Other Long-Term Liabilities pledged revenue for revenue bonds payable for Idaho State University was understated by \$50 million.
- Note 12: Bonds, Notes, and Other Long-Term Liabilities conduit debt reported by the Department of Water Resources for the 2005 North Lake Project (Tamarack) bonds did not agree to the amount confirmed with the trustee. The difference resulted in an understatement of \$7.9 million.

Cause: Weaknesses in the internal controls established by the Office of the State Controller (Office) allowed errors in the financial statements and note disclosures to go undetected.

Effect: The financial statement submitted for audit contained errors that were not material but more than inconsequential. All of these errors were corrected before the *Comprehensive Annual Financial Report* was finalized.

Recommendation: We recommend that the Office improve the design and effectiveness of internal controls over the compilation of the statewide financial statements.

Management's View and Corrective Action Plan: *Documentation for incorporating entity financial statements into the statewide financial report has been improved. Errors identified through our internal review process and by the Legislative Auditors have been noted in our instructions to ensure proper coding going forward.*

Discussions with the Legislative Auditors will be scheduled to renew our understanding of how items will be classified, within the statewide financial statements, in the event an item's classification differs between the Foundation financial statements and the university financial statements. Additionally, we will meet with the college and university and foundations fiscal staff to understand why classifications may differ between entity financial statements.

As noted in this report the Department of Water Resources reported the incorrect amount of conduit debt to our Office. This error was identified when the Legislative Auditors, as part of their audit procedures, confirmed the amount with the trustee. Since 1994 the State Controller has not had the authority to perform post audit functions. Therefore Our Office must rely on the internal controls at each reporting entity and their attestation of those controls and the amounts they report to us. While we will review our internal controls to see if we can identify any weakness in this aspect, at this point we believe our process is appropriate.

Scheduled Completion Date for Corrective Action Plan: July 31, 2014.

Contact Person: Brandon Purcell, CGFM, CFE
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Office of the Idaho State Controller
700 W. State Street
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Phone Number: 208-332-8811

Auditor's Concluding Remarks: We thank the Office for its cooperation and assistance throughout the audit. We recognize the effort the Office has made through training and communications provided to State agencies regarding closing packages and financial reporting. We believe that the Office has statutory authority to perform procedures to ensure State agencies correctly report financial information to the Office. Idaho Code, Section 67-1001, provides that it is the duty of the State Controller to superintend the fiscal concerns of the State with its accounting, informational, payroll, and related data processing services. To assist in this duty, Idaho Code, Section 67-1007, grants authority to the State Controller to examine any documents (books, papers, accounts, vouchers, and other) of any State officers and custodians of State funds. We will review the status of the Office's corrective action during follow-up procedures completed 90 days after issuance of this report.

FINDING 2013-102

Reporting for the Idle Pool in the statewide financial statements contains a \$27.2 million understatement and a \$20.8 million overstatement for a net understatement of \$6.4 million.

Type of Finding: Significant Deficiency

Criteria: Statement No. 31 of the Governmental Accounting Standards Board (GASB), paragraph 7 requires that governmental entities report investments at fair value in the balance sheet. Fair value is the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. This is generally referred to as a mark-to-market adjustment.

Additionally, the COSO published the *Internal Control Integrated Framework* which provides a basis for organizations to design internal control procedures to ensure reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. Components of this framework include risk assessment, control activities, and information and

communication. Risk assessment is the identification and analysis of various risks entities face because of changing economic, industry, regulatory, and operating conditions. It is used to form a basis for how the risks should be managed. Control activities are policies and procedures that help ensure management directives are carried out and risks are mitigated. Verifications, approvals, reconciliations, authorizations, and segregation of duties are all control activities that support this objective. Information and communication is the identification, capture, and exchange of information in a form and timeframe that enables people to carry out their responsibilities.

Condition: The Office performs a year-end analysis of the Idle Pool investments to determine if the difference between book value and fair market value is significant enough to require a mark-to-market adjustment to the statewide financial statements. In fiscal year 2013, the Office developed a new method for this analysis and determined that an adjustment of approximately \$41.4 million should be completed to reduce the value of the Idle Pool. Discussions with the auditors resulted in questions of the validity of data and the appropriateness of amounts used in the analysis process. The Office reversed the entry and re-performed the evaluation using the prior year method. Based on this latest analysis, the Office determined that the difference was less than 1% and concluded that an entry was not necessary. However, the validity of the previous method of analysis is also under question as a better understanding of the underlying data was gained.

In addition, a difference was noted between the amount of cash, net of borrowing limits, as reported in STARS, the statewide accounting system, to the amount reported on the Record of Daily Balances at the end of the fiscal year. The Record of Daily Balances is effectively the bank balance as reported by the Office of the State Treasurer. This difference was not properly resolved through documentation of a reconciling item or adjustment to the statewide financial statements to compensate for the overstatement.

Cause: Under the new method of analyzing the Idle Pool investment values, the Office compared the fair market value, as reported by the Office of the State Treasurer, to the amortized book value also reported by the State Treasurer. The fair market value should instead have been compared to the amount currently recorded in STARS when the financial statements were being compiled.

Also, a complete reconciliation was not performed between the amount of cash as reported by the Office of the State Treasurer and the amount reported in STARS. Differences were not thoroughly investigated, nor were the amounts compared to the Record of Daily Balances.

Effect: The value of the Idle Pool is understated by approximately \$27.2 million because a mark-to-market adjustment was not made. In addition, the Idle Pool is overstated by \$20.8 million because the cash balance could not be supported. These amounts offset to an overall understatement of \$6.4 million for the Idle Pool.

Recommendation: We recommend that the Office continue to gain a greater understanding of the underlying data in STARS and reported by Office of the State Treasurer for the Idle Pool. This understanding should be used to develop an appropriate method of evaluating the mark-to-market adjustment and reconciling cash to supported reports.

Management's View and Corrective Action Plan: *During fiscal year 2013 our Office held a series of meetings and other communication with the State Treasurer's Office. The purpose of the meetings was to gain a better understanding of the underlying data provided to our Office by the State Treasurer's Office regarding the Idle Pool. Additionally, our Office met with Legislative Audit staff to solicit their input on a new methodology. Pursuant to our internal control policy we drafted a document outlining our understanding of the data and our accompanying analysis. As a*

result of our analysis and meetings conducted during fiscal year 2013 we developed a new methodology to determine if an adjustment, referred to as-mark-to-market, was necessary. The Legislative Auditor's methodology may differ from SCO's, however in our opinion the resulting valuation of the Idle Pool was not understated.

Our Office is again reviewing our understanding of the data provided by the State Treasurer's Office and further documenting this understanding. We have contacted the State Treasurer's Office to assist us in this process. Additionally, we are reviewing our understanding of all adjustments in our reconciliation of the differences between cash as reported in STARS and the amount reported on the Record of Daily Balances. Improved documentation for reconciling items or adjustments will be provided going forward. Any change in our understanding and or methodology will be drafted into a document which will be reviewed by our staff, the State Treasurer's Office, and the Legislative Auditors.

Scheduled Completion Date for Corrective Action Plan: July 31, 2014.

Contact Person: Brandon Purcell, CGFM, CFE
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Office of the Idaho State Controller
700 W. State Street
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Auditor's Concluding Remarks: We thank the Office for its cooperation and assistance throughout the audit. We will review the status of the Office's corrective action during follow-up procedures completed 90 days after issuance of this report.

HEALTH AND WELFARE, DEPARTMENT OF

FINDING 2013-103

Hospital assessments of \$14.7 million were levied and collected without statutory authority.

Type of Finding: Material Noncompliance

Criteria: During the 2010 Legislative Session, the Governor signed House Bill No. 656, which went into effect July 1, 2010. It repealed and reissued Idaho Code, Section 56-1404, granting separate authority for the Department of Health and Welfare (Department) to collect increased assessments from hospitals through June 30, 2012. The reissuance of Idaho Code, Section 56-1404, gave the Department authority to collect assessments through the end of fiscal year 2012.

The *Internal Control Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) provides a basis for organizations to design internal control procedures to ensure reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. Components of this framework include risk assessment, control activities, and information and communication. Risk assessment is the identification and analysis of various risks entities face because of changing economic, industry, regulatory, and operating conditions. It is used to form a basis for how the risks should be managed. Control activities are policies and procedures that help ensure management directives are carried out and risks are mitigated. Information and communication is the identification,

capture, and exchange of information in a form and timeframe that enables people to carry out their responsibilities.

Condition: The Department was unaware the statutory authority had expired and continued to charge and collect hospital assessments during fiscal year 2013. House Bill No. 656 contained a sunset clause that restored the statute to its original 2010 status on July 1, 2012. The original statute authorized the assessments for fiscal years 2009, 2010, and 2011; thus, in reverting to the original statute, authority expired. There may have been some misunderstanding by parties involved in the process about the affect of the reissuance of the original Idaho Code section and the intent to continue authorizing the hospital assessments.

Cause: The Department's internal controls designed to ensure compliance with laws and regulations failed to correctly detect the change in statute allowing the collection of assessments without statutory authority.

Effect: The Department billed hospitals for \$14.7 million in assessments that were not statutorily authorized in fiscal year 2013. Based on a letter provided by the Idaho Hospital Association supporting the assessment, we do not believe a liability was required for the financial statements.

Recommendation: We recommend that the Department strengthen internal controls over compliance with laws and regulations to ensure fees charged and collected are appropriately authorized. We also recommend that the Department clarify the purpose and legislative intent for the hospital assessment fees and, if necessary, work to amend Idaho Code, Section 56-1404.

Management's View and Corrective Action Plan: *The Department agrees there is a disconnect between the applicable statute and the Legislative intent that guided the Department's actions. This disconnect occurred because of a ministerial error during the legislative process in drafting the sunset clause in House Bill (HB) No. 656 from the 2010 Legislative Session. It was the undisputed intent of all parties involved to maintain the hospital assessment in FY 2013 and beyond. Below is some background information that added to the collective belief that statutory authority was in place:*

- a) *There is specific wording expressed in the Joint Finance and Appropriations Committee (JFAC) motion sheet discussion supporting the Medicaid appropriations for state fiscal year 2013. It states:*

Hospital Assessment Sunset: This line item funds \$22,400,000, ongoing, from the General Fund to replace dedicated assessment funds that will no longer be available due to the sunset of the Gap/Trustee & Benefit assessment at the end of FY 2012. The department request includes a like reduction in dedicated funds, which this motion does not include. The dedicated fund reduction is zeroed out to allow for the shift in provider assessment contributions from the Gap/Trustee & Benefit assessment to the UPL (Upper Payment Limit) assessment in FY 2013. (Emphasis added.)

- b) *HB 682, the Medicaid appropriations bill from the 2012 Legislative Session, includes nearly \$60 million in spending authority from the Hospital Assessment fund for SFY 2013. If the Legislature did not intend to allow the Department to continue to assess the hospitals, it would not have granted spending authority from the assessment fund.*

- c) *On page 11 of the 2012 Idaho Legislative fiscal report, the following statement expressly refers to the continued assessment for SFY 2013 under the heading “Health Care Provider Assessment Sunset”:*

To offset the impact of the sunset of the statute authorizing the Gap/Trustee and Benefit Assessment allowances, Medicaid received an ongoing General Fund increase of \$36.4 million, which is the amount the three provider types contributed for that purpose in FY 2012. The UPL assessment will remain in place in FY 2013 and beyond, and the department maintained the necessary dedicated and federal spending authority to facilitate. (Emphasis added.)

- d) *During the 2013 legislative session, the supplemental appropriation bill for Medicaid, HB 210, was signed into law on March 15, 2013. This supplemental bill included the same level of Hospital Assessment spending authority for SFY 2013, \$60 million, as the original appropriation bill, HB 682.*
- e) *All of the hospitals assessed in SFY 2013 paid their assessments in a timely manner and without dispute.*

A proposed legislative correction is being submitted this legislative session to remove any doubt about the Department’s statutory authority to make this assessment in future years.

Scheduled Completion Date for Corrective Action Plan: April 30, 2014.

Contact Person: David N. Taylor, CPA, CFE
Deputy Director of Support Services
Idaho Department of Health & Welfare
450 W. State Street, 10th Floor
Boise, ID 83720-0036
Phone Number: 208-334-5500

Auditor’s Concluding Remarks: We thank the Department for its cooperation and assistance throughout the audit. We continue to assert that the Department’s internal controls should have prevented or detected and corrected the noncompliance prior to the audit. We will review the status of the Department’s corrective action during follow-up procedures completed 90 days after issuance of this report.

FINDING 2013-104

Financial reporting processes contain significant deficiencies in internal control allowing several errors in various closing packages to go undetected.

Type of Finding: Significant Deficiency

Criteria: The Committee of Sponsoring Organizations of the Treadway Commission (COSO) published the *Internal Control Integrated Framework* which provides a basis for organizations to design internal control procedures to ensure reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. Components of this framework include risk assessment, control activities, information and communication, and monitoring.

Risk assessment is the identification and analysis of various risks entities face because of changing economic, industry, regulatory, and operating conditions. It is used to form a basis for how the risks should be managed. Control activities are policies and procedures that help ensure management directives are carried out and risks are mitigated. These activities include adequate review and authorization of financial reporting, and using the general ledger or other reliable records as the basis for reports. Information and communication is the identification, capture, and exchange of information, including adequate source documentation to support financial transactions. Monitoring is a process that assesses the quality of an internal control system's performance over time.

As part of the preparation and fair presentation of financial statements, management should establish financial reporting processes for making accounting estimates, including adequate internal control. Such processes include developing or identifying relevant data and assumptions that affect accounting estimates.

Finally, each year, State agencies are required to report accounting information to the Office of the State Controller (SCO) in the form of closing packages, which provide the details necessary to prepare the statewide *CAFR*. The SCO provides instructions for preparing the closing packages in accordance with Generally Accepted Accounting Principles (GAAP).

Condition: The Department's internal control system failed to prevent or detect several misstatements in various closing packages. The most significant errors include:

1. Duplication of data in the compilation of information
2. Expenditure transactions related to goods or services received prior to year-end but paid after year-end not being consistently identified
3. Lack of a process for identifying the accounting period to which specific revenue transactions relate
4. Formula and mathematical errors
5. Use of an outdated federal funding participation rate
6. Failure to estimate activity that would occur after the submission date but prior to the end of the revenue recognition period

These errors resulted in various misstatements within several closing packages and financial statement lines. Below is a summary schedule of the impact of the most significant errors, including the identification of the cause as explained above.

Closing Package	Net Over/(Under) Statement	Cause of Error(s)
Interfund Payables	\$ (1.9 million)	2,6
Accounts Payable	(2.2 million)	1,2
Accounts Payable – Medicaid Payable	1.6 million	4
Accounts Receivable	3.2 million	1,3,4
Accounts Receivable – Deferred Revenue	1.7 million	1,4
Accounts Receivable – Revenue	.4 million	1
Grants Receivable	(3.4 million)	1,2,4,5
Grants Receivable – Deferred Revenue	(1.2 million)	4
Grants Receivable – Revenue	1.2 million	4
Grants Receivable – Long-Term Liability Due Within One Year	(1.6 million)	4

Cause: Review procedures were not performed at the level of detail necessary to detect duplicate information and other errors in closing packages prior to submission to the SCO.

Additionally, monitoring of internal controls failed to detect a significant training issue related to the identification of the proper accounting period for expenditure and revenue transactions.

Finally, closing packages determined to have a higher risk of misstatement were not given additional scrutiny in the review process that would be commensurate with the risk. For example, those closing packages that involve more significant accounting estimates should be identified and additional controls put in place related to the preparation and review of those closing packages.

Effect: The misstatements were not material to the statewide financial statements. However, it is reasonably likely that the deficiencies in the Department's internal control system which allowed these misstatements to be reported would fail to detect a material misstatement in the future. Subsequent to communications with the Department regarding the misstatements noted during the audit, the Department resubmitted information to the SCO to correct many of the misstatements.

Recommendation: We recommend that the Department strengthen the design and effectiveness of internal controls over the completion of closing packages. We also recommend that the Department enhance the monitoring of internal controls to ensure they are operating as designed to comply with GAAP reporting requirements and SCO closing package instructions. We further recommend that the Department strengthen the review process to ensure accurate and reliable financial information is provided to the SCO.

Management's View and Corrective Action Plan: *The Department agrees with the majority of this finding.*

We agree that all conditions, except for condition number six, were present in some closing packages as noted in the findings summary schedule. Therefore, as a result of this finding, the Department has strengthened its training, processes and documentation regarding the submission of closing packages in order to prevent such errors from occurring in the future.

The Department disagrees with condition number six that the Interfund Payables closing package was resubmitted due to the omission of a needed estimate. The resubmission was done to reflect actual accounting activity that later became available, but was unavailable at the time of submission. The State Controller's Office encourages agencies to submit additional information after the initial due date of a closing package if the additional amounts are significant, which is what the Department did in this instance. This is appropriate and not indicative of an error in the original submission.

The Department also disagrees with the report's statement that, "it is reasonably likely that the deficiencies in the Department's internal control system which allowed these misstatements to be reported would fail to detect a material misstatement in the future." We believe our current processes and internal controls are highly capable of preventing such an event from occurring.

Scheduled Completion Date for Corrective Action Plan: August 31, 2014.

Contact Person: David N. Taylor, CPA, CFE
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Boise, ID 83720-0036
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Auditor's Concluding Remarks: We thank the Department for its cooperation and assistance throughout the audit. Related to condition six, we understand and agree regarding the timing and potential resubmission of the Interfund Payable closing package information. However, we continue to assert that the Department's internal controls should have detected and corrected the incomplete information reported in the closing package prior to the audit. We will review the status of the Department's corrective action during follow-up procedures completed 90 days after issuance of this report.

TAX COMMISSION, IDAHO STATE

FINDING 2013-105

Estimates used to determine the amount of taxes receivable accrued at year-end are not properly evaluated for reliability, resulting in misstatements.

Type of Finding: Significant deficiency

Criteria: The Office of the State Controller (SCO) collects information from State agencies on year-end closing packages to make adjustments from cash basis financial statements to accrual basis financial statements. The Accounts Receivable closing package reports the taxes receivable, net of allowances for tax refunds and doubtful accounts, and including estimated amounts to be collected within one year and thereafter.

Auditing and Accounting standards provided by the American Institute of Certified Public Accountants state that revenue is recognized when taxable income is earned and a receivable is reported when revenue is recognized. Derived tax revenues, such as income tax and sales tax, are recognized when the underlying exchange transaction occurs. Standards also state that estimates must be used to arrive at the total derived tax revenue related to the underlying transactions in a fiscal year and the related receivable. It further states that sales and income taxes and other resources to be recovered by tax audit should be recorded, if measurable, in the same period as the underlying transactions regardless of when they are actually collected.

Management is responsible for establishing a process for preparing accounting estimates based on relevant, sufficient, and reliable data. This process should include a comparison of prior accounting estimates with the subsequent results to assess the reliability of the process used to develop the estimates.

Condition: The Idaho State Tax Commission's (Commission) current process for determining the amount to report as taxes receivable is based on estimated amounts. While reviewing this process, we noted procedures are not completed to compare the amounts reported in the prior year as estimated taxes receivable to the actual amounts collected. Without this review, the reliability of the estimates used cannot be verified. Also, the current process does not include amounts for anticipated receipts not yet identified at the end of the fiscal year, including collections from audits, tax discovery, and collections.

Cause: The Commission has no control procedures in place to review prior-year closing package amounts reported, including estimates. The current procedures and calculations also do not include all potential revenue sources that should be recorded as taxes receivable.

GenTax is a stand-alone system used by the Commission to track taxpayer account information including receipts and refunds. At the time of the audit, GenTax reporting parameters could not provide the relevant, sufficient, and reliable data needed to properly review the taxes receivable amounts reported in prior fiscal years.

Effect: An amount for anticipated revenue from audits, tax discovery, and collections was not included in the taxes receivable estimate, resulting in a likely understatement for the fiscal year 2013 receivable amount reported. However, without relevant, sufficient, and reliable data to analyze revenue collected in prior years, the likely amount of the current year understatement cannot be reasonably estimated.

Recommendation: We recommend that the Commission implement closing package procedures to ensure that all tax types and collection methods are considered in the estimate for taxes receivable and that the estimate is compared to actual results for reasonableness.

Management's View and Corrective Action Plan: *We recognize that the current methodology for estimating Taxes Receivable at fiscal year-end presently does not attempt to measure returns or taxable events that have not yet been filed or reported within approximately 60 days after the end of the fiscal year. Although the current method has been mutually developed with the help and guidance of staff at the SCO and used for several years, a change in methodology to measure additional, presumably estimable, future revenues not yet reported or known will be evaluated. Our ultimate objective is to provide the most accurate estimate possible with the continued help, advice, and concurrence of SCO reporting staff and of LSO audit acceptance.*

Scheduled Completion Date for Corrective Action Plan: Completion date is dependent upon the evaluation to be completed by the Commission.

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Auditor's Concluding Remarks: We thank the Commission for its cooperation and assistance throughout the audit. We will review the documentation and instruction changes described in the corrective action during follow-up procedures completed 90 days after issuance of this report.

TREASURER, OFFICE OF THE STATE

FINDING 2013-106

The Office of the State Treasurer inappropriately transferred investments from the Local Government Investment Pool to the Idle Pool resulting in a disproportionate share of investment losses incurred by the State.

Type of Finding: Material Weakness

Criteria: The Office of the State Treasurer (Office) is charged with the authority to invest idle funds of the State, as identified in Idaho Code Section 67-1201(5). The Idle Pool is an internal investment pool consisting of mostly State general and dedicated funds with involuntary participants. Interest received on all permitted investments is to be paid into the general account unless otherwise specifically designated.

The Local Government Investment Pool (LGIP) is an external investment pool with voluntary participants that are mostly local governments, such as counties and municipalities. Participants apply to join the LGIP, and the risk of loss is disclosed in the Statement of Understanding. The LGIP is authorized through Idaho Code, Section 67-1226.

The Office has established investment policies for both pools that refer to the “Prudent Investor Rule” embodied in Idaho Code Title 68 Chapter 5 and Idaho Code, Sections 67-1210 and 67-1210A, to guide investment objectives.

While the Idle Pool and the LGIP have similar investment strategies, the two pools are independent of the other and have separate authorizing legislation. Idaho Code, Section 68-506 states that if a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interest of the beneficiaries. The Idle Pool and LGIP have two distinct sets of beneficiaries with differing interests.

Additionally, the Internal Control Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) identifies control activities that help ensure management directives are carried out throughout the operation. These activities include approvals, authorizations, verifications, reconciliations, and segregation of duties. Even though internal control over financial reporting may appear to be well-designed and effective, controls that are otherwise effective can be overridden by management in every entity. When the opportunity to override internal controls is combined with powerful incentives to meet financial objectives, senior management may engage in detrimental activities or transactions.

Condition: The Office entered into a Securities Lending Agreement in January 2000 which allowed for the cash collateral and investment holdings of the Idle Pool and the LGIP to be comingled in a securities lending portfolio. The lending agent provided separate statements of position for both pools, but also allowed for the allocation and reallocation of assets between the LGIP and the Idle Pool without proper safeguards in place to protect the interests of each individual pool.

On July 29, 2009, the Office directed the securities lending agent to reallocate four asset-backed securities from the LGIP’s account to the Idle Pool’s account. In turn, cash held in the Idle Pool account was reallocated to the LGIP account in the amount of \$31 million. However, based on the investment statements provided by the Office for July 31, 2009, the fair market value of the securities totaled approximately \$19.1 million. The amount of Idle Pool cash reallocated to the LGIP exceeded the fair market value of the four asset-backed securities by approximately \$11.9 million. In addition, the securities were rated below the required AAA by both Moody’s and Standard and Poor’s at the time of the reallocation. Credit quality ratings are given to securities to indicate different levels of exposure to risk. The higher the rating, the lower the risk of loss while the lower the rating, the greater the risk of loss associated with the investment.

As we inquired of the Office about the reallocation of securities, they alerted us to additional reallocations of seven securities that took place in August 2008. The amount of Idle Pool assets reallocated to the LGIP account exceeded the fair market value of the seven securities by approximately \$8.7 million. Based on the investment statements provided by the Office for July 31, 2008, the fair market value of the securities totaled approximately \$46.5 million. In August 2008, approximately \$55.2 million of assets were reallocated from the Idle Pool account to the LGIP's account. In addition, six of the seven securities were rated below the required AAA by both Moody's and Standard and Poor's at the time of the reallocation. The seventh security was unrated by Moody's, while it was rated at AAA by Standard and Poor's.

Cause: In an intentional effort to avoid a likely downgrade of the LGIP rating by Standard and Poor's in 2008 and 2009, the Office reallocated the securities from the LGIP in exchange for Idle Pool assets. The Office provided documentation to show that in the days leading up to the 2009 reallocation of the securities to the Idle Pool, Standard and Poor's had communicated to the Office that a downgrade of the LGIP rating was likely due to holding these specific securities in the LGIP portfolio and that the Office felt that the rating was more important than any other investment. The internal controls established by the Office in its investment policy were overridden when senior management directed the reallocations.

Additionally, the structure of the Securities Lending Agreement allowed the Office to arbitrarily reallocate assets between the investment pools without properly protecting the interest of all affected participants. The comingling and reallocation facets of the agreement led to the ability to manipulate investment pool assets and the financial reporting related to the assets.

As of June 30, 2013, the Office held \$2.9 billion in investments for the Idle Pool and the LGIP without the aid of independent oversight to review investment activity and to ensure fiduciary duties have been considered.

Effect: The State's Idle Pool was unnecessarily exposed to risk and realized losses of \$10.2 million during fiscal year 2013 when most of the reallocated securities were liquidated. The two remaining securities still allocated to the Idle Pool were in an unrealized loss position of approximately \$17.4 million at June 30, 2013. The reallocation activities were not completed in a manner to manage the Idle Pool assets in the sole interest of the Idle Pool participants and did not clearly preserve the fiduciary duty of undivided loyalty.

At June 30, 2012, the combined investment in the Securities Lending Agreement was approximately \$1.2 billion of which \$549 million was allocated to the Idle Pool and \$619 million was allocated to the LGIP. This equates to a pro-rata share of approximately 47 percent and 53 percent, respectively. However, one year later at June 30, 2013, the Idle Pool position in securities lending only decreased by 11 percent to \$489 million while the LGIP position in securities lending had been completely liquidated. The LGIP did not participate in the realized losses related to these transferred securities and now has no exposure to any remaining risk of loss.

Recommendation: We recommend that the Office strengthen processes to reduce the risk of management override of controls. This could include the addition of an independent oversight function in the form an investment board and financial consultants with specific expertise related to investment pools and activities. We also recommend that the Office evaluate the structure of all investments, including securities lending agreements, to ensure the preservation of their fiduciary duty of undivided loyalty to both the State's Idle Pool and the LGIP. The Office should design and implement appropriate internal controls to segregate investment activities and decision making between the two pools. We further recommend that the Office review the Securities Lending

Agreement activity since July 1, 2008, to identify all losses incurred by the Idle Pool due to the inappropriate reallocation of assets.

Management's View and Corrective Action Plan: *We disagree with the finding and certain content as presented within the finding. As we discuss in detail below, the STO's decisions must not be considered in hindsight and require an accurate understanding of the complex investment vehicle known as "securities lending." The STO firmly believes that a person knowledgeable in securities lending with only the information available to the STO at the time of the transaction would conclude that the STO made decisions that were consistent with its duties to the funds in question. Reviewing the situation with the information we have today, we do recognize certain process and control weaknesses were present at the time the decisions were made regarding the securities lending allocation in 2008- 2009. In fact, the STO began implementing substantial changes to management structure, policies and procedures in the fall of 2009 to address those weaknesses. The STO monitors processes and controls on an ongoing basis and implements changes to strengthen controls, policies, and procedures when weaknesses are identified. As a result of this self-monitoring, the STO has stronger processes in place today than it had in 2009.*

The securities lending portfolio is a separately managed external investment pool separate from the internally managed LGIP and IDLE. The internally managed LGIP and IDLE portfolios are independent of one another and are managed accordingly. The finding cited by the audit team stems from a situation occurring in 2008 & 2009 and does not apply to current STO internal investment practices or the policies currently in place for external managers.

Securities lending was a common business practice in 2000, when the securities lending agreement was entered into. However, securities lending is a very complicated investment process and because of this, the STO hired an outside expert as an agent to run the program.

The securities lending agreement executed in 2000 was a standard agreement comprised of standard practices which included comingled or "pooled" collateral accounts. From 2005 to 2007, the securities lending agent engaged by the STO (the "Lending Agent") purchased eleven assets (the "Assets") for the collateral pool managed by the agent for the STO's securities lending program (the "Program"). Under the STO's contract with the Lending Agent, asset purchases must comply with the Cash Collateral Investment Practices ("CCIP") established by the STO. The rating requirement in Idaho Code section 67-1210A mentioned by audit staff applies at the time of purchase. At the time of purchase, the Assets in question each held a rating of AAA and met the standards in the CCIP.

Credit ratings, however, are a single factor that may be considered when making investment decisions and should be used only in conjunction with other investment considerations. Investment decisions should not be made solely on credit ratings. One of the national rating agencies, Standard and Poor's, provides the following illustrative warnings:

- *Credit Ratings are opinions about relative credit risk.*
- *Credit ratings are not investment advice, or buy, hold, or sell recommendations. They are just one factor investors may consider in making investment decisions.*
- *Credit ratings are not indications of the market liquidity of a debt security or its price in the secondary market.*
- *Credit ratings are not guarantees of credit quality or of future credit risk.*

The audit team further draws the conclusion that the reallocation violated the duty of impartiality set forth in Idaho Code section 68-506. The Uniform Prudent Investor Act

requires that a trustee invest and manage the assets of a third party as a prudent investor would, with the exercise of reasonable skill and caution. The trustee's investment and management decisions must be evaluated not in isolation but in the context of the portfolio as a whole and as part of an overall investment strategy. Idaho Code § 68-502. The act specifically provides that "[c]ompliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight." Idaho Code § 68-508.

The duty of impartiality as set forth in the act provides that:

If a trust has two (2) or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

Idaho Code § 68-505. The duty of impartiality is more fully fleshed out in the Third Restatement of Trusts at section 79 and the accompanying comments. The duty is not one of equal treatment but of balancing the naturally conflicting interests of multiple beneficiaries and ensuring that management and administration decisions are not influenced by favoritism or animosity toward a beneficiary. Assuming for the purposes of discussion that the STO is a trustee with respect to the IDLE fund, in this context the duty of impartiality required that the STO's actions recognize the needs of both the LGIP and the IDLE fund and not favor or disfavor either of the funds. Under Idaho Code section 68-502, the analysis of whether the STO's actions were prudent and complied with the duty of impartiality is determined by looking to the facts and circumstances existing at the time of the actions, not by looking in hindsight.

During the time in question, the STO consulted with the Lending Agent concerning the risks of the Assets. The Lending Agent's credit department performed an extensive credit evaluation and concluded that the Assets would pay in full. The STO did not uncover facts discrediting this conclusion in its own review of the matter. The STO reasonably believed that the Assets were not an imprudent risk to the Program as a whole and specifically to either the repayment of the cash collateral deposited by borrowers of the LGIP's securities or the IDLE fund's securities. The information known to the STO at the time was that the LGIP was threatened with a lower rating if the Assets remained associated with the pool. The Lending Agent's reallocation of the Assets addressed this known situation.

The assertion that the STO's internal controls were overridden is false. There was no sale or purchase of the Assets. Without a purchase or sale, the CCIP did not apply and the documentation and approval requirements for a purchase or sale in the Program, or generally in the STO's investment operations, were not triggered. In fact, the agreement with the Lending Agent allowed the Lending Agent broad discretion to control the assets in the collateral pool. See Securities Lending Agreement, para. 2(d) (Except as specifically set forth in the Agreement, the Assets are controlled by and subject only to the instructions of the Lending Agent). The decisions made to reallocate the Assets were a coordinated effort between the Securities Lending agent and the investment manager within the control framework at the time.

Since the allocation occurred, STO has managed the activities of securities lending based on current knowledge and understanding without focusing on activities of the past. The Office has moved to limit exposure of assets under management to securities lending by winding down the securities lending program. We feel that this has been a prudent action considering the losses realized across the country due to securities lending activities during the

unprecedented economic crisis experienced between 2007-2011. Audit staff further references realized and unrealized losses in the finding. While these references are technically accurate, a conscious decision was made to sell certain distressed assets at a time when market conditions were opportune to offset realized losses with realized gains. This decision was made to avoid a detrimental fiscal impact which would have been present if these assets would have stopped performing, thus forcing the general fund to bear the burden of financial loss. The STO has not found it prudent to liquidate the remaining assets referred to in the finding that currently have unrealized losses. These assets continue to receive principal and interest payments monthly and due to the fact that these unrealized losses are held in collateral of a securities lending loan arrangement, any liquidation will need to be a carefully orchestrated effort to ensure all loans are made whole and no contracts are breached.

It is not uncommon for States to comingle funds for investment purposes. At the time, the STO believed our contract protected the interests of each individual pool from undue risk. It is only through the lens of hindsight that the decision is being evaluated. In this case, the investment and management decisions were made after due diligence and consideration of the circumstances known at the time, including a reasonable balancing of the known risks and benefits of an investment decision to both the IDLE account and the LGIP.

Since the events of 2008 and 2009, changes have been made to the organizational structure to improve controls and processes. These changes include improved management structure to encourage increased involvement of investment staff and better communication between investment staff, management, and the State Treasurer. In addition to the structural changes, staff has been added to the investment division to improve the review and reconciliation process and allow for increased segregation of duties. Prior to this audit, the STO selected an independent financial consultant to review strategies and compliance of the investment portfolios and provide reports to the Treasurer that will outline any issues identified by the independent consultant. The Office has also updated processes to include verification of statements made by third party agents.

Scheduled Completion Date for Corrective Action Plan: The Office did not provide a corrective action, so no completion date is expected.

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Auditor's Concluding Remarks: We thank the Office for its assistance throughout the audit. We continue to assert that the Office inappropriately transferred investments from the LGIP to the Idle Pool. As the Office indicates in their response to the finding, the LGIP and Idle Pool are independent of one another. The LGIP and Idle Pool have two sets of beneficiaries with independent interests. The transfers eventually resulted in the disproportionate share of investment losses incurred by the State; however, had the transfer resulted in a disproportionate share of investment gains, we still would have questioned the manner in which the transfers took place, not the end result.

We concur that securities lending transactions do include some complexity; however, in these situations, the securities lending transactions were simply the vehicle used to inappropriately transfer securities and the associated risks from the LGIP to the Idle Pool. The allowance in the Securities Lending Agreement to commingle funds created the opportunity for transfers between independent investment pools. The funds associated with the Securities Lending Agreement were part of an investment vehicle not part of an investment pool comparable to the LGIP and the Idle Pool.

We acknowledge that the Securities Lending Agreement allowed the Lending Agent latitude to allocate and reallocate investments between the independent investment pools. However, the transactions noted in the finding resulted from direct orders from the Treasurer and the Investment Manager. This is supported by electronic communications provided by the Office. On August 6, 2008, the Investment Manager, in a communication to the Treasurer, indicated that the Office contacted our staff under the pretense of inquiring, hypothetically, if a municipality (in general municipalities do not administer investment pools) could make transfers between investment funds. Our staff provided an informal response that an outright purchase and sale would provide means to document the transactions. On August 7, 2008, the Treasurer stated that he would follow the lead of the Investment Manager on the transactions, "...as it is too technical for me. However, I do think that our rating with S&P is more important than any investment vehicle we are using..." Later, on August 8, 2008, the Investment Manager contacted the Lending Agent with the instructions to move the securities from the LGIP securities lending portfolio to the Idle Pool securities lending portfolio.

Prior to the initial transfers in 2008, one of the Office's independent investment advisors inquired about whether or not the State was "...good with moving the securities lending assets/collateral from the DBF/LGIP to the State Idle Fund." The investment advisor inquired about a possible review or approval from the State's Attorney General's Office. The Investment Manager replied that the Attorney General's Office had approved the security transfers. We were not provided documentation to support an official opinion provided by the Attorney General's Office. Based on electronic communications provided by the Office, the transfers that occurred during 2009 were also completed at the direction of the Investment Manager.

In the response to the finding, the Office notes that the Lending Agent provided guidance that estimated the securities transferred in 2009 would fully recover principal amounts. While we respect the estimates of recovery, the transfer of assets at original cost instead of fair market value does not provide appropriate consideration for the risk to which the Idle Pool was exposed and eliminates any investment risk that the LGIP should have borne had the assets remained in their respective pools or been sold through an arm's length transaction. Once again, the Idle Pool assumed the additional risk associated with the securities that were significantly downgraded and in loss positions. If the securities did not have increased risk, there would not have been a likely downgrade of the LGIP rating due to holding the securities and the fair market value would not have been so far below the cost. The Agent communicated that their opinion was that the ratings agencies had overreacted to market conditions in the downgrade of the transferred securities; however, at the time, the ratings were in place and showed increased risk associated with the securities.

In the response to the finding, the Office asserts that internal controls were not overridden because there was no sale or purchase of assets. We respectfully disagree for the following reason. With regard to the transfer that occurred in 2009, the Office's Investment Manager instructed the Lending Agent to transfer cash of approximately \$31 million from the Idle Pool **in exchange** for securities from the LGIP with a fair market value of approximately \$19 million. This is an

exchange transaction that should have been handled at arm's length, should have had adequate internal controls in place to protect the interests of both parties, and should have had appropriate documentation to evidence the transaction. A transaction can include a purchase, sale, loan, pledge, gift, transfer, delivery, or other disposition and, with respect to financial institutions transactions, include deposits, withdrawals, transfers between accounts, exchange of currency, loans, extensions of credit, or purchases and sales of monetary instruments. Not only were the Idle Pool participants unknowingly forced to exchange assets for distressed securities, the transactions were completed at amounts in excess of fair market value. **All of these factors were known at the time of the transactions in 2008 and 2009.** These transactions were also outside of the norm for the Securities Lending Agreement because the Lending Agent was not the decision maker for the reallocations. The internal controls established by the Office were overridden when the senior management directed the reallocations of the assets. The Office was motivated to complete the transfers by the pressure of the likely downgrade of the LGIP rating and a theoretical run on the LGIP by participants due to the possible downgrade. Senior Management had the opportunity to complete the transfers outside of the normal internal control procedures due to the structure of the Securities Lending Agreement which allowed for the comingling of LGIP and Idle Pool assets.

Throughout the Office's response to the finding, there is a theme of viewing the events of the transactions in hindsight. The Office was aware at the time of the transfers in 2008 and 2009 that the LGIP and the Idle Pool were independent from one another. The other factors presented above demonstrate factors that were known at the time of the transfers, such as the lowered rating on the specific investments and Standard and Poor's intent to downgrade the rating of the LGIP specifically in response to the rating on those investments. The consequences associated with the decisions were presented as part of the finding, but those consequences were presented to illustrate the effects of unnecessarily exposing a set of independent beneficiaries to a disproportionate risk.

FINDING 2013-107

The Office of the State Treasurer misclassified one security in the Idle Pool investment closing package.

Type of Finding: Material Weakness

Criteria: The Office is required to submit investment information to the Office of the State Controller as part of the closing package process for inclusion in the statewide *Comprehensive Annual Financial Report (CAFR)*. Closing packages include instructions based on Generally Accepted Accounting Principles (GAAP) to ensure accurate information is submitted by the Office. Governmental Accounting Standards Board (GASB) Statement No. 40 requires information about the concentration of credit risk associated with investments and investments in any one issuer that represents five percent or more of total investments should be disclosed by amount and issuer.

Additionally, the Internal Control Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) identifies control activities that help ensure management directives are carried out throughout the operation. These activities include approvals, authorizations, verifications, reconciliations, and segregation of duties.

Condition: The concentration of credit risk schedule included in the original closing package for the Idle Pool was submitted to the Office of the State Controller with a \$99.9 million security classification error. The securities were purchased with Tax Anticipation Note proceeds and had a trade date of 6/26/13, totaling \$249.9 million. The total was classified as Federal Home Loan Mortgage Corporation securities; however that total included one \$99.9 million Federal Home

Loan Banks security. The two security types are reported separately in the note disclosures to the State's financial statements. The single misclassified security was noted during our review of all 155 securities included in the Idle Pool.

Cause: Weakness in the application of internal controls established by the Office allowed the reporting of the misclassification to go undetected. The Office's closing package preparation process includes a review by a separate staff member, but the misclassification was not identified during the review process.

Effect: A \$99.9 million misclassification in the concentration of credit risk schedule for the Idle Pool was originally reported to the Office of the State Controller for inclusion in the statewide *CAFR*. The misclassification is a material misstatement of a required disclosure associated with the statewide *CAFR*. After our review, the Office submitted a corrected closing package to the Office of the State Controller.

Recommendation: We recommend that the Office strengthen the review process over closing package preparation to ensure that amounts reported in the investment pool schedules are properly classified.

Management's View and Corrective Action Plan: *A classification error within a footnote was made and went undetected through the proper review process. The error caused a 4.7% swing in actual concentration of Federal Home Loan Mortgage Corporation (FHLMC) and Federal Home Loan Bank (FHLB) within the IDLE pool. This resulted in a concentration percentage invested in FHLMC to be adjusted from 21.85% to 17.12% and FHLB to be adjusted from 11.61% to 16.34%. The information was provided for preparation of the concentration risk footnote required by GASB 40. While considering the primary users of the CAFR, the Office questions if this classification error would have a material effect on the decision of a reader. The Office has qualified personnel to prepare and review closing packages, and simply missed classifying one security properly. Although we question whether this misclassification is material, the Office did make the necessary correction. This instance has strengthened our resolve to maintain a detailed review of all security classifications. The Office will continue to apply detailed preparation and review processes to ensure proper classification going forward.*

Scheduled Completion Date for Corrective Action Plan: The Office did not provide a corrective action, so no completion date is expected.

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Auditor's Concluding Remarks: We thank the Office for its cooperation and assistance throughout the audit. We would like to clarify that auditing standards require us to consider many factors when making a judgment about materiality. We are required to determine a quantitative amount for materiality evaluations, and a typical range for materiality is between three and five percent to ensure that the auditor considers both errors that may be detected and the risk that errors may occur and go undetected through our procedures. Further consideration of qualitative aspects related to the required disclosure or error also factor into decisions about materiality. We continue

to assert that the Office did not identify the error through procedures intended to do just that and that the error is significant with regard to both quantitative and qualitative factors.

**STATE OF IDAHO
INTERNAL CONTROL REPORT
SCHEDULE OF PRIOR FINDINGS AND RESPONSES
FOR THE YEAR ENDED JUNE 30, 2012**

		Current Status
CONTROLLER, OFFICE OF THE STATE		
12S-1	Guidance was incorrectly interpreted for recording unsettled trades payable resulting in a material misstatement.	Closed
12S-2	Agencies are using inappropriate signatures on time sheets and failing to maintain employee time records.	Closed
LABOR, DEPARTMENT OF		
12S-3	The Department of Labor accounts receivable closing package included inaccurate and unsupported amounts.	Closed
12S-4	The Department of Labor did not properly account for funds advanced from the federal Unemployment Insurance Program.	Closed
TRANSPORTATION, DEPARTMENT OF		
12S-5	Financial reporting processes contain significant deficiencies in internal control allowing several reporting errors to go undetected.	Closed

**STATE OF IDAHO
INTERNAL CONTROL REPORT
PRIOR FINDINGS AND RESPONSES
FOR THE YEAR ENDED JUNE 30, 2012**

CONTROLLER, OFFICE OF THE STATE

FINDING 12S-1

Guidance was incorrectly interpreted for recording unsettled trades payable resulting in a material misstatement.

Recommendation: We recommend the Office review and correctly implement accounting guidance with particular attention to higher risk areas, such as new or changing accounting standards or financial transactions.

Audit Follow-up: We reviewed progress made on the corrective action plan addressing this recommendation during completion of the fiscal year 2013 statewide financial audit. The Office has adequately implemented the corrective action plan and we consider this finding closed.

Current Status: Closed

FINDING 12S-2

Agencies are using inappropriate signatures on time sheets and failing to maintain employee time records.

Recommendation: We recommend that the Office remind agencies when each electronic signature should be used and implement procedures or controls to ensure the proper use of the electronic signatures.

Audit Follow-up: We reviewed progress made on the corrective action plan addressing this recommendation during completion of the fiscal year 2013 statewide financial audit. The Office has adequately implemented the corrective action plan and we consider this finding closed.

Current Status: Closed

LABOR, DEPARTMENT OF

FINDING 12S-3

The Department of Labor accounts receivable closing package included inaccurate and unsupported amounts.

Recommendation: We recommend that the Department strengthen internal controls to ensure accounts receivable amounts reported in the closing package are accurate and properly supported by accounting records.

Audit Follow-up: We reviewed progress made on the corrective action plan addressing this recommendation during completion of the fiscal year 2013 statewide financial audit. The Office has adequately implemented the corrective action plan and we consider this finding closed.

Current Status: Closed

FINDING 12S-4

The Department of Labor did not properly account for funds advanced from the federal Unemployment Insurance Program.

Recommendation: We recommend that the Department implement internal controls to ensure federal funding activities are reconciled and that amounts drawn for the UI Program correspond to the amounts expended. We also recommend that the Department submit proper closing package information to the Office of the State Controller.

Audit Follow-up: We reviewed progress made on the corrective action plan addressing this recommendation during completion of the fiscal year 2013 statewide financial audit. The Office has adequately implemented the corrective action plan and we consider this finding closed.

Current Status: Closed

TRANSPORTATION, DEPARTMENT OF

FINDING 12S-5

Financial reporting processes contain significant deficiencies in internal control allowing several reporting errors to go undetected.

Recommendation: We recommend the Department improve the design and effectiveness of internal controls over the completion of closing packages. We further recommend the Department strengthen the review process to ensure accurate reliable financial information is provided to the Office of the State Controller.

Audit Follow-up: We reviewed progress made on the corrective action plan addressing this recommendation during completion of the fiscal year 2013 statewide financial audit. The Office has adequately implemented the corrective action plan and we consider this finding closed.

Current Status: Closed

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